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In The

Supreme Court of the United States

October Term, 1976

UNITED STATES OF AMERICA,

Petitioner,

vs.

ONOFRE J. SOTELO and NAOMI SOTELO,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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The undersigned, on behalf of the respondents, hereby submits this brief in opposition to the petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

QUESTION PRESENTED

The respondents disagree with the statement of the question presented in the government's petition. (Petition, p. 2). Respondents submit that the question presented is more properly stated as: Whether the personal liability for the penalty assessed under Section 6672 of the Internal Revenue Code is discharged by the personal bankruptcy of the individual.

STATEMENT

The respondents submit that the statement in the petition omits the relevant fact that on November 29, 1974, the claim of the Internal Revenue Service for unpaid *corporate* taxes was proved and allowed for $32,840.71 in the *personal* bankruptcy. (Petition, App. A, p. 2a).

REASONS FOR NOT GRANTING THE WRIT

The petition intermingles a discussion of the advisability of granting the writ with an argument on the merits of the case. Respondents suggest that these two subjects be separately considered.

I. The Advisability Of Granting The Writ.

The petition claims that in fiscal 1976 a total of $61 million was assessed against individuals under Section 6672, and that a major portion would be jeopardized if the writ is not granted. We dispute that the case is of that degree of fiscal importance because, of the amount collected, most would be collected whether or not the obligation is dischargeable in bankruptcy.

Many persons assessed this penalty are people of means, who, once their liability is established, pay the assessment. Others are persons who are or become impoverished, dead, or not found, so that the question of legal liability is irrelevant to any actual collection. Others are partners or sole proprietors of the underlying business activity, so that their personal liability is direct and not dependent on the formality of an assessment under Section 6672.

The petition erroneously assumes that legal liability is the equivalent of collection, and ignores the inevitable loss caused by persons who cannot pay under any circumstances. The petition also erroneously assumes that everyone assessed under Section 6672 is a person with no assets, who will immediately file a personal bankruptcy, and who, after bankruptcy, miraculously acquires sufficient assets to pay the claim in full. It also ignores the fact that the underlying business entity often

has assets which pay the tax itself, in whole or in part, thereby relieving the individual *pro tanto*.

In many cases more than one individual may be responsible for the penalty, and the government may pursue all of them. See 29 Tax Lawyer 621 (Spring 1976), Appendix A, *infra*, p. 1a. In such cases, bankruptcy of one person would not affect the ability of the government to collect from another.

The question presented is one of statutory construction needed to harmonize conflicting provisions of the Bankruptcy Act and the Internal Revenue Code. Both statutes are written in an atmosphere of great social and economic pressure, and are the products of peculiarly political processes. We suggest that the better course is for Congress to resolve this conflict, rather than the Court.

An example of the Congressional process we recommend took place in *United States v. Byrum*, 408 U.S. 125. This Court interpreted the term "enjoyment" of property as used in 26 U.S.C. sec. 2036(a), and held that a decedent who retained voting rights to stock transferred to an inter vivos trust did not retain "enjoyment" of the property. This decision involved a highly technical area of estate taxation and Congress reacted to it by amending this section in the Tax Reform Act of 1976, P.L. 94-455 (26 U.S.C. 2036(a), (App. B, *infra*, p. 2a). An additional sentence was added to the section which specifically provided that "the retention of voting rights in retained stock shall be considered to be a retention of enjoyment of such stock." Such congressional action bears out Mr. Justice Powell's observation that, "When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences." *United States v. Byrum*,

408 U.S. 125, at 135. We predict a similar Congressional reaction to the case at bar, regardless of how it might be decided on its merits.

Presented with the acknowledged conflict between the Courts of Appeal, Congress may well clarify its intention, rendering a decision by this Court unnecessary. In making the choice, it will be useful to Congress to have legislative facts available to observe what effect the differences between the Circuits have on revenue. The Seventh Circuit, according to the 1970 Census, had a population of 20,725,578 out of a total population of the United States of 203,184,772. The position of the government has been challenged in a geographical area containing about 10% of the national population. This will produce a representative sample of experience for Congress to evaluate without creating an undue risk.

If, after a reasonable time, Congress does not act, and the Court determines that a national rule is needed on the point involved, certiorari can be granted in some future case. The nature of the problem is such that it will inevitably arise in future cases. When it does, and if the Court determines that the matter is really as serious as the government would lead us to believe, and if Congress has not resolved the question, then certiorari can be granted and the merits decided by this Court.

II. The Merits Of The Case.

The bankrupt in this case has received his discharge in bankruptcy, which discharges him from all provable debts except those which are specifically classed as non-dischargeable by statute. The claim of the Internal Revenue Service in this case was proved and allowed by the Bankruptcy Judge. "Provable debts are presump-

tively dischargeable, and the burden of showing that a particular liability is within one of the statutory exemptions, as against an assertion of release by discharge in bankruptcy, is on the creditor." 8 *Remington on Bankruptcy*, § 3315, lists cases upholding this theory. The applicable statute is 11 U.S.C. 35(a) which provides that "a discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as are *taxes* which became legally due and owing by the bankrupt to the United States . . ." [emphasis supplied].

Upon close examination of this situation, it can be seen that the underlying tax involved was not a tax on the bankrupt, but rather was a tax on the corporation. Care must be taken to distinguish the *personal liability* of the bankrupt for a penalty based on the corporate tax, from the question of the *dischargeability* of that personal obligation, which is the question presented.

The fact that a person is liable to pay the taxes of another does not of itself give rise to a non-dischargeable debt. 8 *Remington on Bankruptcy*, § 3317. We submit that the liability of the bankrupt for a penalty based on the tax of the corporation is not a *tax* on him, but is a compensatory penalty. It is a penalty because the statute itself says the responsible person shall "be liable to a *penalty* equal to the total amount of the tax . . . not . . . paid over." (26 U.S.C. 6672) [emphasis supplied]. It is compensatory because the only purpose of the personal liability involved is to collect money owed, and its payment reduces the related tax *pro tanto*.

The question as to whether the penalty is compensatory or punitive in nature goes to the question of whether or not it is dischargeable in bankruptcy. 8 *Remington on Bankruptcy*, § 3304. Compensatory penal-

ties are dischargeable while punitive penalties are not. For this reason, non-dischargeable punitive penalties are not allowed to share in the assets of the bankrupt estate, because the punishment would then fall on the other creditors, rather than the bankrupt. We specifically point out that the government's claim was proved and allowed in this case, and therefore shares in both the personal and corporate assets.

Many reported cases characterize the penalty imposed by Section 6672 as a "tax" although the statute itself says "penalty". The government cites a group of cases for this characterization, such as *Kelly v. Lethert*, 362 F.2d 629 (C.A. 8, 1966). These cases involve determination of *liability* rather than *dischargeability*, so the distinction between "tax" and "penalty" is not crucial to these decisions.

The entire line of authorities cited in the petition for the idea that "penalty" equals "tax" can be traced back to *Botta v. Scanlon*, 314 F.2d 392 (C.A. 2, 1962). The holding there was that "penalty" equals "tax" for the purpose of the anti-injunction provisions of the Internal Revenue Code. (26 U.S.C. 7421(a), Appendix C, *infra*, p. 3a).

The *Botta* court correctly based its decision on Section 6671 of the Internal Revenue Code (26 U.S.C. 6671, App. D, *infra*, p. 3a) which provides:

> "any reference in this title [which includes the Anti-Injunction Statute] to 'tax' imposed by this title shall be deemed also to refer to the penalties and liabilities provided by this subchapter [which includes Section 6672]."

No provision equivalent to Section 6671 applies to references to "taxes" in the Bankruptcy Act. *Botta's* holding that a Section 6672 "penalty" is a "tax" for

purposes of the Anti-Injunction Statute, premised as it is on the clear language of Section 6671, should not be extended to the bankruptcy context.

Shortly after *Botta* was decided, it was misinterpreted as applicable to a bankruptcy situation. *Sherwood v. United States*, 228 F.Supp. 247 (E.D., N.Y. 1964). All of the cases thereafter decided on the point in question then relied on *Botta*, interpreted by *Sherwood*. Until the Court of Appeals for the Seventh Circuit decided the case at bar with a full analysis of the question, there were no decisions giving any reasoned analysis for repudiating the statutory characterization Congress put on the personal liability.

The two appellate decisions contrary to the case at bar are *per curiam* affirmances. *Murphy v. Internal Revenue Service*, 533 F.2d 941 (C.A. 5) affirming 381 F.Supp. 813 (N.D.Ala.) and *Lackey v. United States*, 538 F.2d 592 (C.A.4). Both of these cases rely on the District Court opinion in *Murphy* as their basis. In the course of that District Court opinion, the observation is made:

> ". . . the plight of the bankrupt is one that naturally incites sympathy and tends to provoke compassion. The purpose of bankruptcy to give the bankrupt a new start in life and to free him from the burden of his debts is frustrated by a proceeding which does not discharge him from paying taxes created by a corporate enterprise which ended in financial disaster and in his own personal financial ruin."

In spite of such language, the District Court in *Murphy* refused a discharge on the authority of *Botta*, which, as mentioned, was not a bankruptcy case.

The petition argues that permitting bankruptcy to discharge penalties assessed under Section 6672 would lessen the incentive for corporate officers to do their

duties conscientiously (Petition, p. 7). This argument is illusory. If a corporation goes bankrupt, its stock becomes worthless; and when a corporate officer goes bankrupt, all his non-exempt property is lost. There is no profit to a corporate officer discharged from liability for Section 6672 penalties, and no financial incentive to attain such a miserable circumstance. The former corporate officer in this situation is ruined financially whether discharged or not. The denial of the discharge means that a further continuing liability is created unrelated to property, earning ability, health, or any other relevant criteria. We submit that such a drastic conclusion should be reached only if specifically directed.

To eliminate the fraudulent use of bankruptcy for the avoidance of personal liability for the Section 6672 penalty, the government can rely on the exception which make nondischargeable any debts which were created by ". . . fraud, embezzlement, misappropriation, or defalcation while acting as an officer . . ." (11 U.S.C. 35(a)(4)). There is also criminal liability as mentioned in the petition. (Petition, p. 9).

The petition resorts to legislative history to sustain its characterization of the personal obligation. Legislative history is not needed to sustain the characterization obtained from the words of Section 6672 itself, which says this is a "penalty". There is no ambiguity for which reference to legislative history is needed. The various legislative historical papers cited, however, all refer to the discharge of *taxes of the bankrupt*, and there is no reference to show that Section 6672 penalties are taxes for this purpose.

The policy of the Bankruptcy Act gives debtors a fresh start is an overriding consideration when balanced against the non-dischargeability of certain debts. It is

clear that Congress intended that the liability of certain persons for their own individual taxes would not be dischargeable. It is also clear that Congress intended that persons holding certain corporate positions would be personally liable to see that certain taxes of the corporation are paid. It does not necessarily follow, however, that the derivative liability of the corporate officer is non-dischargeable. That liability is simply a suretyship relationship between the government and the individual in which the individual simply owes a debt to the government.

When people are held liable for their own taxes, there is some rational connection between the liability and the assets which were or are owned by the individual. This nexus is absent when someone is held liable for a corporate tax. The vicarious liability for the corporate tax might be vastly in excess of the resources owned, or whichever could be owned, by the hapless individual. It is bad enough to take personal assets for corporate debts, but it is unreasonable to confiscate all future earnings of a bankrupt for the loss of assets which were never his. A fundamental policy of the Bankruptcy Act is subverted unless the individual discharged is permitted to rehabilitate himself and his family out of future earnings.

If Congress had intended to impose a tax under Section 6672, then words imposing a tax would have been utilized; but that section does not impose a tax. It imposes a compensatory penalty personally chargeable to an individual. If it is a compensatory penalty it is dischargeable in bankruptcy.

Ours is a society where private risk of capital is rewarded and encouraged. Although it is essential that the government be financed, it is also essential that individuals be permitted to start anew if their personal fortune has been risked and lost. Imposing permanent economic servitude on the unfortunate corporate officer whose employer has failed may well be within the power of Congress, but such a harsh result should not be presumed in the absence of a clear congressional mandate.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX A

29 Tax Lawyer 621 (Spring 1976):

11. *Employment Tax Penalties: Collection Procedure*

Section 6672 imposes a 100 percent penalty for nonpayment of employment and withholding taxes against any person responsible for the payment of these taxes. To ensure collection, the policy of the Service is to assess the full penalty against all responsible persons. Until recently, it was extremely difficult for taxpayers and Service personnel alike to ascertain whether all or a portion of the penalty had previously been paid by one of the other responsible persons. As a result, the same penalty could be paid two or three times.

It is understood that the Service, in an effort to prevent multiple payments, is initiating a new procedure to centralize and coordinate collection of employment tax penalties.

APPENDIX B

Internal Revenue Code of 1954 (26 U.S.C.)

Section 2036(a)

(a) *General Rule.* The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

For purposes of paragraph (1), the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock.

The Tax Reform Act of 1976, P.L. 94-455, sec. 2009(a), (e)(1):

Added the last sentence to Section 2036(a) of the Internal Revenue Code to read as above, effective for transfers made after June 22, 1976.

APPENDIX C

Internal Revenue Code of 1954 (26 U.S.C.):

Section 7421(a)

"(a) *Tax.* Except as provided in sections 6212(a) and (c), 6213(a), and 7426(a) and (b)(1), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

Section 6671

(a) *Penalty Assessed As Tax.* The penalties and liabilities provided by this subchapter shall be paid upon notice and demand by the Secretary, and shall be assessed and collected in the same manner as taxes. Except as otherwise provided, any reference in this title to "tax" imposed by this title shall be deemed also to refer to the penalties and liabilities provided by this subchapter.

(b) *Person Defined.* The term "person", as used in this subchapter, includes an officer or employee of a corporation, or a member or employee of a partnership who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.